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No. 87-2026

In the Supreme Court of the United States

OCTOBER TERM, 1988

JAMES E. SOCHIN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

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Petitioner contends that the courts below erred in finding that purported commodity trades engaged in by petitioner were "shams" that did not generate deductible losses.

1. During the years 1979-1981, petitioner, along with more than 1400 other individuals, participated in a tax shelter program operated by Gregory Investment and Management, Inc. (GIM) and Gregory Government Securities, Inc. (GGS). The program was designed to generate substantial tax losses for the participants by means of a "straddle."[1] The participants purportedly invested in "forward contracts"[2] to buy and sell certificates issued by the Government National Mortgage Association

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[1] A "straddle" involves the simultaneous holding of a buy and a sell position in similar commodities.

[2] A "forward contract" is like a futures contract, *i.e.*, an agreement to buy or sell a specific quantity of a commodity at a specified price on a specified future date.

("Ginnie Maes") and the Federal Home Loan Mortgage Corporation ("Freddie Macs"), and the investments purportedly were tailored to the client's own forecast of the movement of interest rates. Under the program, GIM served as a financial adviser to prospective investors, while GGS was the seller or buyer in each transaction. GGS purported to use an elaborate multi-step pricing formula to determine the fees that it would charge under the various contracts that it entered into with its clients, but the formula provided that GGS could make any adjustment that it deemed appropriate. The agreement signed by each client provided that GGS could liquidate any open position or cancel any order whenever it considered it necessary for its protection, without notice to the client. The client also was required to execute a power of attorney in favor of GIM. Pet. App. A4-A5, A23-A24.

The client would give GGS a deposit (which generally was the greater of $10,000 or .125% of the face value of his investments) and furnish GIM with an interest rate forecast. In return, the client would receive a portfolio of forward contracts in Ginnie Maes and Freddie Macs, which GGM and GIS advised could be expected to generate a tax deduction of approximately $10 for each $1 of deposit, regardless of the accuracy of the forecast. This original portfolio constituted a straddle or series of straddles, since 50% of the contracts were to purchase securities (long positions), and 50% were to deliver securities (short positions). Any significant change in the prevailing interest rate would result in a loss position in one "leg" of the straddle and a gain position in the other "leg." When interest rates had moved enough to generate the amount of the desired tax loss, the "loss" positions were cancelled, which purported to create an ordinary loss for the investor in the year of cancellation. Pet. App. A4-A5, A21-A22, A25.

After the cancellation of the loss positions, the straddle was immediately reestablished by providing the client with a position similar to the one that had just been cancelled, thereby "locking in" the gain inherent in the leg that had been retained. After the gain inherent in the client's positions had been deferred for a period generally exceeding 16 months, all positions in the account were purportedly assigned to a third party that was closely associated with GGS: For a flat fee of $100 per assignment, for which GGS was reimbursed by its clients, the third party immediately assigned the contracts back to GGS at the same price, thus completing the circle. The amount that had been "owed" by each client to GGS with respect to the initial cancellation of the client's "loss" positions was offset against the approximately equal amount "owed" by GGS to the client as a result of the assignment of the gain positions. The client then paid GGS a fee for administering the program. No client ever actually purchased or sold Ginnie Maes or Freddie Macs. Pet. App. A5, A22, A40-A41.

Petitioner invested $2,000 in the program. He claimed a $20,800 ordinary loss deduction with respect to that "investment" on his return for 1979, and reported a $21,961 net long-term capital gain on his return for 1981. The net gain of $1,881 before taxes was reduced to a net overall profit of $461 after the deduction of $1,420 in fees paid to GGS. Petitioner also participated in the tax shelter program in 1980 and 1981. The transactions were similar to those connected to his 1979 investment, except that he experienced slight net losses rather than gains in each year. Pet. App. A6, A38.

2. The Commissioner disallowed the loss deductions claimed by petitioner with respect to his participation in the tax shelter program, determining that the entire arrangement was an artifice having no economic effect other

than the purported creation of tax benefits.[3] Petitioner sought redetermination of the resulting deficiencies in the Tax Court, which upheld the Commissioner's determination in a unanimous, reviewed opinion (Pet. App. A13-A52). The Tax Court found that the transactions were "factual shams" (*id.* at A47), *i.e.*, that the "commodity trades" occurred only on paper in an artificial, self-contained market in which there was no bona fide prospect of economic gain (aside from tax benefits), nor any actual risk of economic loss (*id.* at A45-A47).

The court of appeals affirmed, holding that the Tax Court's conclusion that the transactions were factual shams was not clearly erroneous (Pet. App. A1-A12). The court rejected petitioner's claim that the Tax Court had applied the wrong legal standard to the sham inquiry, stating that the court correctly "reviewed the transactions for economic effects other than the creation of income tax losses, and in doing so considered both economic substance and business purpose" (*id.* at A8). The court then upheld the finding of a sham, concluding that petitioner "invested in a program designed to reap the tax benefits of real market investments without bearing the consequent risks" (*id.* at A11 (footnote omitted)).

3. Petitioner contends that the straddle transactions were not shams, but rather legitimate investments that could generate tax losses. This contention was correctly rejected by both courts below, and there is no reason for this Court to review their factbound determination.

Because of the complete control that GGS maintained over the forward contract transactions and the circular nature of the cycle of trades, it is apparent that petitioner

[3] The Commissioner also eliminated the capital gain that petitioner had reported in connection with the subsequent cancellation of the other leg of the straddle.

did not have a genuine investment in Ginnie Maes and Freddie Macs; rather, he was a participant in a contrived "self-contained market operated and controlled by Mr. Gregory and his affiliates" (Pet. App. A10) that had no economic effect on the participants, but rather served only to generate tax losses. As the court of appeals found, "[t]he absolute power that [petitioner] conferred upon GGS to set contract prices and perform any act to alter existing contractual obligations, combined with the fact that no contract was ever enforced, entitled the tax court to infer that the entire program existed solely to provide tax benefits" (*ibid.* (footnote omitted)). Moreover, the "losses" taken on the client's tax returns had no real economic effect. They were simply debited to the client's account and carried on GGS's books without margin call or collection. The gain inherent in the remaining leg of the straddle was "locked in" and, when the rest of the contracts were cancelled, the gain was applied to the client's account to offset the debit generated by the earlier "loss." None of the contracts that GGS entered into on behalf of its clients ever resulted in the delivery of the underlying security. In these circumstances, the courts below plainly were correct in concluding that the transactions were devoid of economic substance and therefore a nullity for federal tax purposes. And that conclusion accords with the holdings of other circuits that have considered similar contrived commodity straddles. See *Forseth* v. *Commissioner*, 845 F.2d 746 (7th Cir. 1988); *Mahoney* v. *Commissioner*, 808 F.2d 1219 (6th Cir. 1987); *Wooldridge* v. *Commissioner*, 800 F.2d 266 (11th Cir. 1986) (Table).

Petitioner contends (Pet. 14-16) that the decision below conflicts with *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89 (4th Cir. 1985), and *United States* v. *Philatelic Leasing, Ltd.*, 794 F.2d 781 (2d Cir. 1986). Petitioner asserts that these decisions establish a two-part test under

which a transaction can be held to be a sham for tax purposes only if it is shown both that the taxpayer had no motivation for entering the transacton other than to obtain tax benefits and that the transaction had no economic substance. Because the court of appeals below declined to apply "a rigid two-step analysis" (Pet. App. A7), petitioner contends that it created a conflict in the circuits. This contention is without merit.

To the extent that the differences cited by petitioner in the formulation of the standard are more than semantical and could be significant in some factual situations (and we note that in both cases relied upon by petitioner the court of appeals agreed with the government that the transactions were shams), it is clear that they do not point to different results under the facts of this case. The Tax Court found that the transactions were "factual shams * * * designed * * * for the sole purpose of attempting to achieve tax losses for their investors" (Pet. App. A47 (footnote omitted)), and the court of appeals upheld that finding. Thus, the factual conclusion of the courts below was both that petitioner had no motive for entering the transactions other than to obtain tax benefits and that the transactions lacked economic substance; under any formulation, the transactions must be regarded as shams. Indeed, that this case would not have come out any differently under the "two-part test" cited by petitioner is manifested by the fact that the language on which petitioners rely has its source in a Tax Court opinion (see *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985), citing 81 T.C. 184, 209 (1983)), yet the Tax Court in this case—in a unanimous, reviewed opinion—found that the transactions were shams.[4]

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[4] Petitioner argues (Pet. 13) that the issue presented in this case is important because "Congress has enacted specific legislation to allow

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

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straddle losses as deductions for income tax purposes" where the transactions are not shams. We note that the legislation to which petitioner refers, Section 108(a) of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 630, was recently amended by Congress to reduce substantially the availability of deductions for straddle losses, Section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2817. The Tax Court had held under the 1984 statute that straddle losses were allowable as long as it could be said that the transaction had a reasonable prospect of any profit, even if the primary motive for the straddle was to obtain tax losses. *Miller* v. *Commissioner*, 84 T.C. 827 (1985), rev'd, 836 F.2d 1274 (10th Cir. 1988). The Tax Court has now held in a unanimous, reviewed opinion that *Miller* should no longer be followed in light of the 1986 amendment and that straddle losses can be allowed only where the taxpayer demonstrates that he entered into the straddle transaction primarily for profit. *Boswell* v. *Commissioner*, 91 T.C. No. 15 (July 26, 1988).

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